DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

Release Number: **201223021**
Release Date: 6/8/2012
Date: March 14, 2012
Uniform Issue List:
512.00-00

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

Legend:

M =

Dear

This is in response to your request for rulings that endowment investment agreements will not generate unrelated business taxable income under section 512 of the Internal Revenue Code (the "Code") and that redemption of endowment units by charitable remainder trusts will be treated as long or short term capital gain or loss under section 1222 of the Code, depending upon the applicable holding period.

M is exempt under section 501(a) of the Code as an organization described in section 501(c)(3) and has been classified as an educational organization under sections 509(a)(1) and 170(b)(1)(A)(ii).

M is the trustee of a number of charitable remainder trusts (collectively, "the Trusts") and as trustee, M is the legal owner of the Trusts' assets. In addition, M has a remainder interest in each of the Trusts. You are one such charitable remainder trust in which M is trustee and remainder beneficiary.

As a result of the relationship with the Trusts as both trustee and beneficiary, M has a substantial interest in the value of each Trust. Moreover, the donors to the Trusts have funded the Trusts with the intention that M benefit substantially from the remainder value of the Trusts, and that the Trusts' assets will be managed to achieve the greatest possible return on investment.

M's endowment is invested in a diversified portfolio of public domestic and international equity and fixed income securities, real assets, private equity and hedged strategies.

M proposes to create a contractual obligation, pursuant to which it would issue a contract right to each of the Trusts to receive a proportionate share, or "unit", of M's endowment in exchange for the investment of the Trusts' assets in M's endowment. The contract right would entitle the Trusts to receive periodic payments based on the units owned by each of the Trusts. M determines a payout rate on the endowment each year based in part on the endowment's investment performance. M calculates the market value of each endowment unit on a monthly basis. The market value of each endowment unit initially equals the total value of the endowment investments divided by the number of outstanding units and is subsequently adjusted in accordance with the market value of the endowment. Each Trust is entitled to an amount equal to the payout rate multiplied by the number of units it holds.

M seeks to enable the Trusts to be invested in the same manner as M's endowment. A Trust would acquire a unit in the endowment which would give the Trusts a contractual right against M, but no interest whatsoever in the underlying investment assets of the endowment. The contract between M and the Trusts would provide that the price of the units would equal their value at the time of acquisition. The units would have the same value that M uses for internal accounting purposes.

The contract would provide that each Trust would receive payments on the units held by it based on the payout rate M establishes for the endowment, with payouts made quarterly. A Trust could choose either to reinvest all or part of the payout, or redeem additional units, depending on its cash requirements. The Trusts will treat payouts as ordinary income, regardless of the character of the underlying income of the endowment, whether capital gain, ordinary income or return of capital.

Under the contract, the Trusts would not have any ownership interest in the underlying assets of the endowment. The Trusts would have no power or right of any kind to control, direct, supervise, recommend or review M's business activities, operations or decisions with respect to the endowment. They would not have the right to veto or opt out of any of the underlying endowment investments. The contract would provide that, with respect to the issuance of units, M is neither a partner nor an agent of the Trusts, the Trusts would never be liable for any cost, expense or payment incurred by M or for which M is liable or responsible relating to the endowment (or the underlying endowment assets), and M would indemnify and hold the Trusts harmless from and against any liability arising out of any action or inaction by M with respect to the endowment (or the underlying endowment assets).

You have requested the following rulings:

The issuance of endowment units by M to you, the making or receipt of payments with respect to the endowment units, and the holding or redemption of the endowment units, will not generate unrelated business taxable income to you.

The redemption of endowment units by you will be treated as long or short term capital gain or loss under section 1222, depending upon the holding period of the endowment units.

Section 6.14 of Rev. Proc. 2011-4 provides that the Service will not issue letter rulings pertaining to unrelated business income tax issues arising when charitable lead trust assets are invested with charitable organizations. The ruling issued by this letter relates only to your participation as a charitable remainder trust in M's endowment.

LAW

Section 664(c) of the Code provides that a charitable remainder trust shall, for any taxable year, not be subject to tax unless such trust, for such year, has unrelated business income (within the meaning of section 512 of the Code, determined as if part III of subchapter F applied to such trust).

Section 511 of the Code, in part, imposes a tax on the unrelated business taxable income of organizations described in section 501(c)(3).

Section 512(a)(1) of the Code defines the term "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business regularly carried on by it, less the allowable deductions which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in section 512(b).

Section 512(b) of the Code sets forth so-called "modifications," which are excluded from the computation of unrelated business taxable income. These modifications include dividends, interest, royalties, rent from real property and gain from the sale of property.

Section 513(a) of the Code defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its exempt purpose or function.

Section 513(c) of the Code provides that the term "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services.

Section 1.513-1(a) of the Income Tax Regulations provides that gross income of an exempt organization subject to the tax imposed by section 511 of the Code is includible in the computation of unrelated business taxable income if: (1) it is income from a trade or business; (2) such trade or business is regularly carried on by the organization; and (3) the conduct of such trade or business is not substantially related (other than through the production of funds) to the organization's performance of its exempt functions.

Section 1.513-1(b) of the regulations provides that, for purposes of section 513 of the Code, the term "trade or business" has the same meaning it has in section 162 and generally includes any activity carried on for the production of income from the sale of goods or performance of services.

Section 1.513-1(c)(1) of the regulations provides that in determining whether trade or business from which a particular amount of gross income derives is "regularly carried on," within the meaning of section 512 of the Code, regard must be had to the frequency and continuity with which the activities productive of the income are conducted and the manner in which they are pursued. For example, specific business activities of an exempt organization will ordinarily be deemed to be "regularly carried on" if they manifest a frequency and continuity, and are pursued in a manner generally similar to comparable commercial activities of non-exempt organizations.

Section 1.513-1(d)(1) of the regulations provides that, in general, gross income derives from "unrelated trade or business," within the meaning of section 513(a) of the Code, if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted. The presence of this requirement necessitates an examination of the relationship between the business activities which generate the particular income in question -- the activities, that is, of producing or distributing the goods or performing the services involved -- and the accomplishment of the organization's exempt purposes.

Section 1.513-1(d)(2) of the regulations provides that trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes, and is "substantially related," for purposes of section 513 of the Code, only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular amount of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Where the production or distribution of the goods or the performance of the services does not contribute importantly to the accomplishment of the exempt purposes of an organization, the income from the sale of the goods or the performance of the services does not derive from the conduct of related trade or business. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

As noted previously, organizations described in section 501(c)(3) of the Code are subject to tax on their unrelated business income under section 511. In order for such an organization's income to be subject to the unrelated business income tax, three requirements must be met: (1) the income must be from a trade or business; (2) the trade or business must be regularly carried on; and (3) the conduct of the trade or business must not be substantially related to the organization's exempt purpose or function. <u>See</u> section 1.513-1(a) of the regulations.

Section 1222 of the Code provides that capital gain or loss is generated upon a sale or exchange of a capital asset.

Section 1234A of the Code provides that gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer shall be treated as gain or loss from the sale of a capital asset.

Section 1221 of the Code defines the term "capital asset" as property held by the taxpayer, regardless of whether it is connected with the taxpayer's trade or business, unless the property meets one of eight listed exceptions: (1) inventory; (2) property of a character which is subject to the allowance for depreciation provided in § 167, or real property used in a trade or business; (3) certain intangible property; (4) accounts receivable acquired in the ordinary course of a trade or business; (5) certain publications of the United States Government; (6) certain commodities financial derivatives; (7) certain hedging transactions; and (8) supplies of a type regularly consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer.

Although section 1221 appears to give broad meaning to the term capital asset, the Supreme Court has found it "evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions [of section 1221] qualifies as a capital asset;" rather, "the term 'capital asset' is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time ...." Commissioner v. Gillette Motor Transport, Inc., 364 U.S. 130 (1960) (citing Burnet v. Harmel, 287 U.S. 103 (1932)). Accordingly, the Court has held that certain interests that are concededly "property" in the ordinary sense are not capital assets.

On this basis, capital gain treatment has been denied for transactions involving payments in return for interests carved out of, or related to, an interest retained by the taxpayer. See e.g., Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958) (Court denied capital gain treatment on the disposition of certain mineral payments carved out of established oil and gas interests); Hort v. Commissioner, 313 U.S. 28 (1941) (Court denied capital gain treatment on the disposition of a term of years carved out from a fee simple).

The Court also has denied capital gain treatment for transactions on the basis that the payments at issue were a substitute for ordinary income. In Hort, for example, the taxpayer inherited a building, and one of the tenants canceled its lease, paying the taxpayer a cancellation fee. The Court held that the cancellation fee was ordinary income because the cancellation of the lease involved nothing more than relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises. Id. at 32. The Court bolstered this "substitute-for-ordinary-income" doctrine in P.G. Lake, stating, "The lump sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income." P.G. Lake, 356 U.S at 265.

Consistent with the substitute-for-ordinary-income doctrine, the courts have denied capital gain treatment for transactions involving interests related to compensation for past or future personal services. See, e.g., Freese v. United States, 455 F.2d 1146 (10th Cir. 1972) (lump sum representing unpaid commissions due under an employment contract); Elliot v. United States, 431 F.2d 1149 (10th Cir. 1970) (lump sum paid for the surrender of right to future sales commissions); Holt v. Commissioner, 303 F.2d 687 (9th Cir. 1962) (payment for interest in films to be produced by taxpayer). Similarly, courts have denied capital gain treatment for interests relating to income already earned or about to be earned. See, e.g., United States v. Midland-Ross Corp., 381 U.S. 54 (1965) (earned original issue discount); Lattera v. Commissioner, 437 F.3d 399 (3d Cir. 2006) (lump sum payment for annual installments of lottery prize); Rhodes' Estate v. Commissioner, 131 F.2d 50 (6th Cir. 1942) (right to dividend that was already declared).

On the other hand, as the courts have noted, "Simply because the property transferred will produce ordinary income, and such income is a major factor in determining the value of the property, does not necessarily mean that the amount received for the property is essentially a lump-sum substitute for ordinary income." Guggenheim v. Commissioner, 46 T.C. 559, 569 (1966). In Guggenheim, the court focused on whether the taxpayer transferred substantial investment risks in the sale of undivided interests in a stallion. In that case, the court noted that if the value of the stallion subsequently increased, the taxpayer would not share in that increase with regard to the interests transferred. Instead, the new owners received all the benefits of an increase in value of the stallion, and all the burdens of a decrease in value. Thus, the court found that the taxpayer had transferred substantial investment risks and was entitled to capital gain treatment on the sale of the interests.

In United States v. Dresser Industries, Inc., 324 F 2d. 56 (5th Cir. 1963), the court distinguished between proceeds from the present sale of the future right to earn income, which is capital gain, and the present sale of the future right to earned income, which is ordinary income. Id. at 59. In that case, the court found that the sale of an income-producing asset was not merely the sale of the right to income already earned; instead, the taxpayer had an asset that would produce income in the future. Thus, the court held that the taxpayer's sale of the asset generated capital gain. Id. Similarly, in Commissioner v. Ferrer, 304 F 2d. 125 (2d Cir. 1962), the court held that the taxpayer's surrender of a lease of a play constituted the sale or exchange of a capital asset, despite the fact that receipts from the play would have been ordinary income. Ferrer at 132. In its rejection of the government's argument against capital gain treatment, the court noted that there was no equivalence between amounts paid for the surrender of the lease and the income that would have been realized by its retention. Id. at 133.

ANALYSIS

M proposes to enter into a contractual relationship with certain Trusts that are charitable remainder trusts in which it has an interest as a beneficiary and serves as trustee of the Trusts. Under such a contractual relationship, you would receive payments on the units held by it based on the payout rate M establishes for its endowment, with payouts made quarterly.

You would acquire units from M's endowment, which would give you a contractual right against M, but no interest whatsoever in the underlying investment assets of the endowment. The contract between you and M would provide that the price of the units would equal their value at the time of acquisition. The units would have the same value that M uses for internal accounting purposes.

Consequently, you could choose either to reinvest all or part of the payout, or redeem a portion of the units, depending on your cash requirements. Thus, under the contractual relationship with M, you would have a right to the payout declared by M plus the right to redeem the units at the value that M uses for internal accounting purposes.

As stated above, under the contract, you would not have any ownership interest in the underlying assets of the endowment or any contract rights with respect to any other Trusts. You would have no power or right of any kind to control, direct, supervise, recommend or review M's business activities, operations or decisions with respect to the endowment. You would not have any right to veto or opt out of any of the underlying endowment investments. The contract would provide that, with respect to the issuance of the units, M is neither a partner nor an agent of you, you would never be liable for any cost, expense, or payment incurred by M or for which M is liable or responsible relating to the endowment (or the underlying endowment assets), and M would indemnify and hold you harmless from and against any liability arising out of any action or inaction by M with respect to the endowment (or the underlying endowment assets).

You do not have a position of ownership in the underlying assets of M's endowment. Because the contractual relationship between M and you is not in the nature of a partnership or agency, the income earned by you from the payout M establishes for the units reflects ordinary income and does not take on the character of the income of the underlying assets or debt-financed or unrelated business taxable income. M would pay any tax owed on unrelated business taxable income earned by the endowment portfolio, with no deduction taken for any payments made to you.

With respect to the proper characterization under section 1221 of the unit, the bundle of contract rights represented by each unit is property, and may be treated as a capital asset for purposes of section 1221. In the present case, none of the listed exceptions in section 1221 applies. The most important characteristic of the unit is that significant investment risks are associated with, and included in, each unit. With respect to each unit there is an opportunity for appreciation as well as a risk of loss. Each unit represents a substantial investment by you, and each unit has an ascertainable basis. The value of each unit is directly tied to the endowment's investment performance; poor performance will detract from the value of a unit, while performance above the payout rate set by M will increase the value of each unit. The opportunity for appreciation, risk of loss, and basis in each unit are characteristics similar to other contract rights that are treated as capital assets (for example, other financial derivatives, mutual fund shares or corporate stock). Further, the benefits and burdens associated with each unit are similar to those associated with the property held to be capital assets in Guggenheim, Dresser and Ferrer.

In addition, although you will receive ordinary income in the form of the quarterly payouts that are based in part upon the number of units owned by you, consideration received upon a redemption of a unit is not a substitute for what would otherwise be received as an ordinary income payout, whether due and payable or about to be due and payable to you under the terms of the contract. Rather, the amount paid for a unit upon a redemption is equal to the value of the unit on the date of redemption. Unit value on any given date is equal to overall asset value of the endowment divided by the number of units outstanding. In addition, the unit is not an interest related to compensation for past or future personal services. Instead, the unit is an asset that will produce income in the future.

Finally, the unit does not represent a carve-out of a larger estate retained by you. The appreciation of each unit is attributable to M's overall endowment property appreciation, much of which, in turn, is attributable to increases in the value of capital assets in M's endowment. The contract provides specifically that you do not have any ownership interest in or rights to M's endowment.

Accordingly, we conclude that the unit is a capital asset for purposes of section 1221. Furthermore, section 1234A will apply to treat gain or loss from the cancellation, lapse, expiration, or other termination of the unit as gain or loss from the sale of a capital asset. Thus, in general, the redemption of the unit by you will generate short-term or long-term capital gain or loss to you, depending on the holding period of the unit.

In view of the foregoing, we rule as follows:

1. The issuance of endowment units from M to you, the making or receipt of payments with respect to the endowment units, and the holding or redemption of the endowment units, will not generate unrelated business taxable income to you.

2. The redemption of endowment units by you will be treated as long or short term capital gain or loss under section 1222, depending upon the holding period of the endowment units.

This ruling letter is based on the understanding that there will be no material changes in the facts upon which it is based.

We express no opinion as to the tax consequences of the proposed transaction under any other section of the Code.

Pursuant to a Power of Attorney on file in this office, a copy of this letter is being sent to your authorized representatives. A copy of this letter should be kept in your permanent records.

This ruling letter is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited by others as precedent.

If there are any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely,

Director, Exempt Organizations

Enclosure
Notice 437